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C O N F I D E N T I A L SECTION 01 OF 02 BAGHDAD 002854

SIPDIS

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SUBJECT: IRAQI DINAR CASH CRUNCH: TIGHT BUT MANAGEABLE

REF: A. BAGHDAD O/I 8/11/2008

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Classified By: Economic Counselor Michael Dodman for reasons 1.4(b) and (d)

I1. (C) Summary: Iraq's vastly increased public spending combined with bureaucratic delays in the purchase of new cash supplies by the Central Bank of Iraq, an antiquated and not-yet interconnected banking sector, and continued reliance on cash payments for government salaries has caused a cash crunch in Iraq. Based on current rates of disbursement, we believe that the banks have a sufficient supply of vault cash Iraqi Dinars to meet government payrolls and other demands for the next two weeks. The Central Bank is expecting a new cash shipment to arrive in September, but some provincial bank branches are reporting that their dinar supply is dangerously low. Intervention by the Embassy's Public Finance Management Action Group helped to avert a crisis with the Ministry of Defense, ensuring that sufficient funds were available to meet payroll needs for the security services going into the month of Ramadan. End Summary.

Enough Cash -- But Not Where it's Needed

I2. (SBU) Based on information from the Central Bank of Iraq (CBI), we believe that based on current expenditure levels, banks have a sufficient supply of Iraqi Dinars (IQD) to meet government payrolls until at least mid-September. Banks in Iraq currently hold approximately IQD 1.7 trillion (USD 1.4 billion) in vault cash. This far exceeds the IQD 400 billion needed to meet the banks vault cash reserve requirements. Despite the banking system overall having sufficient dinar notes, certain bank branches have indicated that their cash-on-hand is not enough to meet their customer demands. This is a particular problem for Iraq since GOI payrolls, for the most part, are paid in cash, and it comes at a time when many Iraqis increase their spending in celebration of the beginning of Ramadan. The situation is tight, but manageable.

I3. (SBU) Highlighting this problem was a September 1 report from PRT Diyala that there had been no cash shipment from Baghdad to Diyala since August 6. As a result, the five central Diyala Rafidain bank branches have been forced to postpone almost all cash disbursements, including the large numbers of end-of-month government employee and teacher salaries as well as payments to pensioners. Diyala Supervisor-General for Banks Salih Rasheed told the PRT that the Rafidain headquarters in Baghdad claimed that it also had no reserves, but expected replenishment from the CBI by next week.

Payroll System Compounds the Problem

I4. (SBU) The Government of Iraq's payment system continues to be cash-based. Government payroll rosters are compiled at

the local accounting offices of each ministry and then passed on to a main accounting office such as the Governorate Treasury or an Accounting Department of a ministry branch. At this level the rosters are aggregated and sent to the headquarters of the Ministry of Finance (MoF). The MoF then orders a cash transfer, which is done with physical cash by vehicle, to the branch of either the Rafidain Bank or Rasheed Bank nearest to the local accounting office of the ministry. In the case of the Ministry of Defense, cash transfers are made to the Rafidain Bank branch at the Ministry of Defense in Baghdad and collected there monthly by regional military paymasters who then transport the cash back to their units.

¶15. (SBU) A more efficient system of transferring funds among banks has not yet been adopted by most state-owned banks though some private banks are now transferring funds electronically and using ad hoc interbank borrowing facilities. To overcome the current payroll crunch, state-owned banks are just beginning to transfer cash between their own branches in order to meet needs in various geographic areas. This effort is piece-meal, however and not always sufficient to meet needs.

Budget Expenditures Also Play a Role

¶16. (SBU) Data from the Ministry of Finance indicate that the GOI spent over (IQD) 4 trillion (USD 3.7 billion) domestically in both May and June, and over IQD 3 trillion (2.5 billion) in July. Yet current account balances at the CBI remain high as it continues to remove IQD from the

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economy by appreciating the dinar against the dollar through its foreign exchange (FX) auctions. To keep inflation in check, the CBI has soaked up IQD 17.9 trillion (USD 15.1 billion) through FX auctions so far in 2008; over the same period, the GOI has transferred IQD 17.9 trillion for domestic expenditures.

New Money is Coming -- But Not Fast Enough

¶17. (C) As reported Ref A, delays in the CBI's printing of new banknotes and a failure to calculate the increased demand for cash caused by recent civil service pay increases and more aggressive GOI domestic spending have exacerbated this cash crunch. Lacking dinar cash, Iraqi banks have increased their disbursement of the USD notes that they also maintain as vault cash. CBI data also show a significant spike in USD sales in July and August, somewhat undercutting its previous efforts in "de-dollarizing" the Iraqi economy.

¶18. (C) The CBI, which had injected IQD 8 trillion (USD 6.7 million) worth of new dinar notes earlier in 2008, informed us that it expects a cash shipment of IQD 800 billion (USD 670 million) to arrive shortly. This shipment will consist of 32 million IQD 25,000 (USD 21) denomination notes and be sufficient to meet roughly one week of cash demand. The CBI has ordered a total of approximately IQD 3 trillion (USD 2.5 billion). (Note: TREASATT advocacy and efforts with the CBI led to the GOI being willing to accept currency printed at DeLaRue's Nairobi, Kenya facility, which has spare line capacity. This should allow regular cash shipments to begin.
End note.)

¶19. (C) The CBI reported on September 4, that it has been able to meet cash demands on a daily basis -- roughly IQD 20-30 million -- because private banks are continuing to deposit cash in the CBI's vaults. Private banks offer a higher average rate of interest on retail deposits than the state-owned banks.

Close Call at the Ministry of Defense;
PFMAG to the Rescue

¶10. (C) The cash crunch, when combined with bureaucratic squabbles between the MoF and the Ministry of Defense (MoD) over the MoF's desire for the MoD to close out its FY 2006 and 2007 books created conditions where there was real doubt whether there would be sufficient cash available at the MoD's Rafidain Bank branch for August wage payments. The Embassy's Public Finance Management Action Group (PFMAG), through intervention with the MoF, MoD, CBI and the Rafidain Bank, secured an agreement from the CBI to supply IQD 25 billion (USD 21 million) in cash shipments for security ministries payments. This averted what would have been a real crisis as military paymasters were unwilling to return back to their units without cash for salaries during the lead-up to Ramadan.

Comment

¶11. (C) Iraq's antiquated and inefficient reliance on cash for all nearly transactions, and especially cash for payrolls, pensions, and many other types of government spending, when combined with state-owned banks whose branches are not inter-connected makes the flow of new bank notes from the Central Bank's vaults a fiscal jugular vein. Political dangers exist when banks used for public salaries and disbursements run low on cash. Yet there are some steps that Iraqis could take fairly easily. For example, individual Iraqi bank branches could meet their own cash needs by issuing short-term certificates of deposit or other incentives to encourage the depositing of some of the approximately IQD 20 trillion (USD 17 billion) cash estimated to be in circulation. The good news is that Iraqis are not strangers to this type of problem and have developed coping mechanisms such as running up tabs at local shops. The Embassy's Public Finance Management Action Group (PFMAG) will continue to closely monitor this problem and seek to both address the underlying causes and symptoms of this problem.

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